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Auditing Profession Bill
Director: Local Government Implementation
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PRETORIA
0001

11 February 2005

Dear Sir

COMMENTS ON THE DRAFT AUDITING PROFESSION BILL AND THE PROPOSED REVISIONS TO THE COMPANIES ACT

We welcome the opportunity to provide you with comments on the above.

We support the drive to ensure independent, robust and balanced regulation of the auditing profession but are concerned about a number of matters of principle. These are elaborated on in our detail comments.

Part 1 of our comments deals with the draft Bill and Part 2 contains comments on the proposed amendments to the Companies Act necessitated by the Bill. For ease of reference our comments follow the numerical sequence of the sections. The more important points are shaded.

Please do not hesitate to contact me on (011) 797 4312 if you would like to discuss our comments. We would also welcome the opportunity to have a discussion with you to explain our comments in further detail.

Yours sincerely

S.P. Kana
Deputy CEO

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PART 1 DRAFT AUDITING PROFESSION BILL

Chapter I Definitions and Establishment of Boards

Definitions

"1. "audit" means the examination of –

> **(b) financial and other information, prepared in accordance with appropriate criteria, with the objective of expressing an opinion on the financial and other information. "**

Comments

The first part of subsection (b) refers to the examination of "financial and other" information. Where "other information" is being examined, the objective will be to express an opinion thereon. The words "and other" should be inserted as indicated above.

"1. "auditing pronouncements" include Statements of South African Auditing Standards, practice statements, guides and circulars developed or adopted and issued by the SBA;"

Comments

The Draft Auditing Profession Bill (the Bill) has not incorporated the Auditing and Assurance Standards Board (AASB) of the Public Accountants' and Auditors' Board (PAAB)'s decision to adopt the entire suite of auditing pronouncements issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) for use in South Africa on 1 January 2005. The IAASB pronouncements will replace South African Auditing Standards (SAAS). The term "Statements of South African Auditing Standards" should be replaced with "pronouncements issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC)" This comment applies to all references in the Bill to SAAS, for example the reference to SAAS in Section 20(2)(a).

"1. "firm" means a partnership or company such as is described in paragraphs (a) and (b) of section *12(1)*;"

Comments

The definition of ***"firm"*** should include a sole practitioner.

Chapter II Independent Regulatory Board for Auditors, Accreditation and Registration

Education and training

The Bill is drafted on the principle of the Independent Regulatory Board for Auditors (IRBA) granting accreditation to professional bodies meeting certain requirements. The Bill is drafted in such a manner that the IRBA will have no direct responsibility for the education and training of candidates who are allowed entry to the profession. We are concerned that this could result in blanket accreditation as "registered auditors" of all members of professional bodies where the professional bodies' education and training standards do not specifically focus on "auditing" or "auditor" related qualifications. To ensure public trust in the profession, it is vital that the IRBA should maintain consistent qualification standards for all "registered auditors". We recommend that the Bill empower the IRBA to retain the power to set examinations and continuing education requirements that must be passed by persons wishing to register as auditors. The IRBA should be able to prescribe, set and administer the examinations.

Independence of the IRBA

Although a maximum of two-fifths of the members of the IRBA may be registered auditors, section 5(1)(d) indicates that the IRBA will be funded solely by registered auditors. This funding structure implies that the IRBA will not be deemed to be independent from its accredited bodies. This could impact on, for example, the Public Company Accounting Oversight Board (PCAOB) or the European Regulators recognising the regulation performed by the IRBA. The Ministerial Panel for the Review of the Draft Accountancy Profession Bill suggested that all stakeholders, in particular government, provide funding for the profession's regulatory body, and we support this suggestion.

IRBA: Composition and succession to property etc.

"3.(2) In the making of appointments under subsection (1), the Minister must secure that, disregarding any temporary vacancy in its membership, not more than two-fifths of the members of the IRBA are registered auditors."

Comments

The Bill does not establish a minimum number of the IRBA members who should be registered auditors. While it is essential that the IRBA should be independent of the profession, the profession should at least be represented on the Board.

Chapter III Functions and Composition of Subsidiary Boards

"19.(1)(d) influence the nature of international auditing pronouncements by –

(i) preparing and submitting comment on exposure drafts or discussion papers and replies to questionnaires by the International Auditing Practices Committee of IFAC or a successor body; "

Comments

The International Auditing Practices Committee (APC) of IFAC has already been superseded by the International Auditing and Assurance Standards Board (IAASB). We suggest that the Bill refer to the "International Auditing or Assurance Standards Board or a successor body". This comment applies to all references to the APC in the Bill.

Chapter IV Powers and Duties of Registered Auditors and Reviews by IRBA

Unmodified opinions

"20. (1) Unless a registered auditor who is conducting the audit of an entity is satisfied about the criteria specified in subsection (2), the auditor may not, without such qualifications or modifications as may be appropriate in the circumstances, express an opinion to the effect that any financial statement, ~~including any annex thereto~~, which relates to the entity, fairly represents, in all material respects, the financial position of the entity and the results of its operations and cashflow."

Comments

Scope of section 20

Section 20 only applies to the audit of financial statements. This is not consistent with the definition of "audit" in section 1 which includes the "examination of financial and other information". We believe that the scope of section 20 should include all assurance engagements.

Annexures to the financial statements

The reference to "including any annex thereto" can create the impression that the auditor's opinion includes annexures to the financial statements. "Financial statements" should have the same meaning as intended by International Financial Reporting Standards and/or the Companies Act. We propose that "including any annex thereto" be deleted.

"20. (2) The criteria referred to in subsection (1) are –

> **(a) that the auditor has carried out the audit free from any restrictions whatsoever and in compliance, so far as applicable, with Statements of South African Auditing Standards relating to the conduct of the audit; and**
>
> **(b) that proper accounting records in one of the official languages of the Republic have been kept in connection with the entity in question so as to reflect and explain all its transactions and record all its assets and liabilities correctly and adequately; and**
>
> **(c) that the auditor has obtained all information, vouchers and other documents which in the auditor's opinion were necessary for the performance of the auditor's duties; and**
>
> **(d) that the auditor has not had occasion, in the course of the audit or otherwise during the period to which the audit relates, to send a report to the IRBA under section 22(2) relating to a reportable irregularity, or that, if such a report was so sent, the auditor has been able, prior to expressing the opinion referred to in subsection (1), to send to the IRBA a notification under section 22(3) that the auditor has become satisfied that no reportable irregularity has taken place or is taking place."**

Comments

We believe that sections 20(2) (b) and (c) are antiquated. The requirements for performing an audit engagement as set out in the pronouncements of the IAASB of the IFAC encompass and expand on the requirements of subsections (b) and (c). We suggest that subsections 2(b) and 2(c) be removed.

Auditor responsible for keeping accounting records

"20. (3) If a registered auditor or, where the registered auditor is a member of a firm, any other member of that firm was responsible for keeping the books, records or accounts of an entity, the auditor must, in reporting on anything in connection with the business or financial affairs of the entity, indicate that

the auditor or that other member of the firm was responsible for keeping those accounting records. "

Comments

We find this reporting requirement excessive and recommend that it be restricted to reports issued on the financial statements.

Auditor having financial interest in entity excluded from audit

"21. (1) A registered auditor may not conduct the audit of any financial statements of an entity (whether as an individual auditor or as a member of a firm) if, at any time during a period to which those financial statements relate or at any time during the two years ending at the beginning of that period the auditor has or had a financial interest in the entity.

(2) In subsection (1) "financial interest" means a financial interest of any description whatsoever (and whether direct or indirect), other than -

> **(a) a right to fees or charges earned by the auditor (or the firm of which the auditor is a member) in respect of services; or**
>
> **(b) in the case of an entity which is or includes a pension fund organisation or which provides a collective investment scheme, any interest in the fund or scheme which gives the auditor no greater right to participate in the making of decisions as to the management of the entity than any other member of the fund or scheme.**

(3) In subsection (2)(b), -

> **(a) "pension fund organisation" has the same meaning as in the Pension Fund Act 1956 (Act No. 24 of 1956); and**
>
> **(b) "collective investment scheme" has the same meaning as in the Collective Investment Schemes Control Act 2002 (Act No. 45 of 2002)."**

Comments

We do not believe that auditor independence should be legislated. Auditor independence should be regulated by the Standard-Setting Board for Auditor Ethics (SBE). The objectives , powers and duties of the SBE as set out in sections 15 and 16 accommodate this suggestion.

We agree that, from the date of accepting an audit engagement, registered auditors (as defined in the Bill) should comply with all ethical requirements (for example the IFAC Code of Ethics for Professional Accountants (the IFAC Code of Ethics)) regarding independence. However, this section in the Bill will require audit firms to ensure that all their audit partners and prospective audit partners are free

of financial interest (as defined in the Bill) in all *prospective* clients for a period of two years prior to accepting an engagement. This will effectively prohibit all audit partners of holding any equity investments, irrespective of whether or not an investee is an audit client of that firm. This requirement is impracticable and we suggest that it be removed.

Furthermore, section 21, read with the definition of "financial interest" in the Bill, is more onerous than the requirements of the IFAC Code of Ethics. The Bill prohibits *any* financial interest in an entity, including loans from and deposits with an entity that is a bank, even if this was done under normal commercial terms. The IFAC Code of Ethics accepts that certain loans from and deposits with an assurance client that is a bank (refer to paragraphs 8.124 to 8.129) will not create a threat to independence. This requirement in the Bill is also impracticable.

It appears that the terms "registered auditor" and "auditor" as used in this section refer to individuals and not to firms registered with the IRBA. If this section is retained in the Bill it should be redrafted to consistently refer to "registered auditors" as defined in the Bill.

Reportable irregularities

General comments

The current legislation contained in section 20(5) of the PAAB Act has been a useful tool to auditors in alerting the PAAB about material irregularities. There are sections in the current legislation that could be improved on, for example the timing of reporting such irregularities, but on the whole, we have found the requirements of section 20(5) to be practicable. The Bill has not improved on either the identification of reportable irregularities or the process of reporting them. In contrast to section 20(5), the Bill's requirements are impracticable, unclear, could discourage auditors from reporting reportable irregularities and could delay the reporting process. We strongly suggest a revision of the existing section 20(5) of the PAAB Act rather than a complete redraft of this legislation as currently proposed by the Bill. We believe the section in the Bill dealing with reportable irregularities will not serve the public interest.

Identifying reportable irregularities

"22. (1) In this section –

> **"reportable irregularity" means any unlawful act or omission committed by any person in the conduct of the management or control of an entity, which -**

(a) has caused or is likely to cause financial loss which is material to the entity or to any partner, member, shareholder or creditor of the entity; or
(b) is fraudulent or amounts to theft or is otherwise dishonest; or
(c) represents a material breach of any fiduciary duty owed by such person to any entity itself or any partner, member, shareholder or creditor of the entity, or under any law applying to the entity or the conduct or management thereof;"

Comments

Subsection (a) obliges the auditor to judge financial materiality from the perspective of third parties ("any partner, member, shareholder or creditor"). The auditor would ordinarily not have access to the financial information of third parties to be in a position of making this judgement. It furthermore reduces the consideration of materiality to the least significant party involved (the entity, any partner, member, shareholder or creditor), which makes this reporting responsibility extremely onerous. We recommend that the references to third parties be removed.

Section 22(1)(b) requires all acts or omissions that are "fraudulent" or "amounts to theft" or are "otherwise dishonest" to be reported, irrespective of the quantum of the amounts involved. We envisage that auditors would generally not be in a position to conclude on whether or not acts or omissions were "fraudulent", "amounts to theft" or were "otherwise dishonest" without the benefit of a court ruling, and would only act once such a ruling had been obtained. This could significantly delay the timing of reporting reportable irregularities to the relevant regulators.

Reporting reportable irregularities

We support the Bill's proposals of reporting reportable irregularities sooner to the IRBA than material irregularities are currently reported to the PAAB in terms of section 20(5) of the PAAB Act. However, we believe that this should be a matter of judgement: If in the auditor's judgement it is unlikely that the irregularity will be rectified within 30 days, it should be reported to the IRBA immediately, as suggested by section 22. If, however, in the auditor's judgement it is likely that the irregularity will be rectified within 30 days, it should only be reported to the members of the management board of the entity, with them having 30 days to satisfy the auditor that the reportable irregularity did not take place or has been rectified. If the entity fails to satisfy the auditor within the given 30 days, the auditor should immediately report the matter to the IRBA.

Limitation of liability of auditor for opinions, reports, statements etc.

Section 23 does not contain any reform regarding auditors' liability.

Reform regarding the limitation of auditor liability is already evident in a number of countries: Canada and Australia have both recently enacted laws designed to introduce systems of proportionate liability for auditors; Ten member states of the European Union permit some form of limitation of an auditor's liability, either by way of limitation imposed by law (Austria, Germany, Greece and Slovenia), permitting auditors to limit their liability on a contractual basis (Denmark, Latvia, Lithuania and Poland) or having a liability regime that assesses auditors' responsibility on a proportionate basis (France and Malta); Indications are that proportionate liability established by contract will appear in the United Kingdom Companies Bill (expected in 2005).

The public's interest is not served when excessive litigation and unreasonable costs of resolving lawsuits discourage risk taking and investment and discourage entry of the best people into the profession. Our firm strongly supports reform to a legal environment that presents disproportionate and potentially catastrophic consequences that even the largest auditing firms do not have the resources or capital to cover. We are not advocating the elimination of liability when defects occur, whether in financial reporting by companies or in auditing by auditing firms and remain committed to improve audit quality and to reduce the occurrence of audit defects. But exposure to liability must be proportionate and fair.

The effect of unlimited liability as illustrated by the collapse of a big firm like Arthur Anderson, and the cost and/or unavailability of professional insurance premiums required to cover this risk, could be a barrier to emerging firms that wish to expand their public interest practices.

We recommend that a framework of proportionate liability be introduced to the Bill to replace the current situation of unlimited liability. We believe this will enhance competition within the audit market and attract talented people to the profession to ultimately ensure audits of the highest quality.

PART 2 COMPANIES ACT, 1973: PROPOSED AMENDMENTS TO FURTHER ENHANCE THE INTEGRITY AND INDEPENDENCE OF THE SOUTH AFRICAN AUDITING PROFESSION

Definition of limited purpose company

"A "limited purpose company" is defined as a private company that does not:

- **(i) take deposits or loans from the public;**
- **(ii) offer its shares to the public; or**
- **(iii) act as a holding company in respect of a public interest company; and**
- **(iv) is not a subsidiary or associate of, or joint venture with a public interest company,**

that is authorized by unanimous consent of its members to operate as a limited purpose company for purposes of the Companies Act; provided that such consent is given annually in respect of each supervening financial year."

Comments

It is our understanding that the proposed amendments to the Companies Act (the limited amendments) which were released concurrently with the Bill will be incorporated into the Companies Act prior to the completion of the revision of the Companies Act (the Act) as part of the Department of Trade and Industry's Corporate Law Reform project. We understand that the only implications of the introduction of the definition of "public interest company" and "limited purpose company" to the current text of the Companies Act, are to

- i) identify those companies that are required to appoint an audit committee,
- ii) distinguish the auditor's responsibilities regarding attending certain meetings of the board of directors and the company for public interest and limited purpose companies; and to
- iii) regulate audit partner rotation for certain companies.

The definitions will have to be reconsidered once the Corporate Law Reform project has been finalised.

Subsection (ii) as quoted above should refer to "securities" and not "shares".

We suggest that "supervening" be replaced with "subsequent".

Independence of auditors

"In considering whether a registered auditor is independent of a company, the audit committee must determine if the auditor, in respect of services other than auditing or permitted non-audit services (see paragraph 3.3.6):

(i) receives any remuneration or other direct or indirect benefit from;
(ii) undertakes any consultancy, advisory or other work for; or
(iii) is connected, directly or indirectly, with;

the company or any subsidiary or parent of the company or, if the company is a member of a group, any other member of the group.

Where a registered auditor has previously been appointed as auditor of the company, audit committee must consider whether the auditor's independence may have been prejudiced as a result of such an appointment."

Comments

The meaning of "is connected, directly or indirectly, with" in subsection (iii) should be clarified.

It is not clear whether or not "other members of the group" includes associates and joint ventures as defined in International Financial Reporting Standards.

While the audit committee of a company will probably be able to obtain information regarding non-permitted non-audit services provided by the auditor to the company and its subsidiaries, we are not convinced that the audit committee will have access to information regarding such services provided by the auditor to the company's parent and to other members of the group, which makes these requirements impracticable.

Independence of directors

"A director is an independent non-executive director if (except as a director and member of the audit committee) the director:
> Does not receive any direct or indirect remuneration or other benefit from;
> Does not undertake any consultancy, advisory or other work for; and
> Is not directly or indirectly connected with;
the company or any subsidiary or parent of the company or, if the company is a member of a group, any other member of the group."

Comments

The meaning of "is connected, directly or indirectly, with" in subsection (iii) should be clarified.

It is not clear whether or not "other members of the group" includes associates and joint ventures as defined in International Financial Reporting Standards.

Appointment of firm as auditor

"2.3.4 Appointment of firm as auditor
The appointment of a firm as the auditor of a public interest company will be valid only if, in addition to the name of the firm, the appointment specifies the name of the individual registered auditor who is the member of the firm that will undertakes the audit."

Comments

In terms of current legislation, audit firms and not individual audit partners, accept and perform audit engagements. While an individual audit partner will take responsibility for the engagement, that partner will draw on the skills of a national or global organisation (the audit firm). In situations of an audit failure, the firm would normally be the defendant in a lawsuit (if any). Individual partners alone will normally not be defendants in their personal capacities.

This amendment to the Act appears to indicate a shift towards direct personal liability of specified individual audit partners. This is contrary to the global shift towards auditor liability reform as discussed in our comments in Part 1 above. We do not support this amendment.

Rotation of auditors

"2.3.5 Rotation of auditors
The same individual may not serve as the nominated auditor of a public interest company for more than four consecutive financial years. Where an individual has served as the nominated auditor of a public interest company for two or more consecutive financial years and then ceases to be the nominated auditor, the individual may not again become the nominated auditor of that company until after the expiry of at least two further financial years."

Comments

Rotation period:

We believe that a rotation period of four years is too short. Business has become complex and sufficient time is needed to understand any new client properly. We recommend that a rotation period in line with international regulation be determined, for example:

Article 40, *Independence*, of the proposed European Union 8th Company Law Directive states that the statutory auditor or the key audit partner responsible for carrying out the statutory audit on behalf of the audit firm shall rotate from the statutory audit engagement within a maximum period of five years.

The SEC rules implementing the requirements of the Sarbanes-Oxley Act require engagement partners and concurring review partners to rotate after five years.

The IFAC Code of Ethics (paragraph 8.151) states that the lead engagement partner of a listed audit client should be rotated after a pre-defined period, normally no more than seven years.

A period of four years could also hinder empowerment if partners are not allowed sufficient time to develop their skills on any particular assignment.

We suggest a rotation period for public interest clients of five years.

"Nominated auditor"

We suggest that the Act should use terminology that is consistent with the IAASB pronouncements. "Nominated auditor" should be replaced by "engagement partner" to be consistent with ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements* and ISA 220, *Quality Control for Audits of Historical Financial Information.*